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SUBJECT: REVENUES AND EXPENDITURES UP IN DRAFT 2006 BUDGET

REF: A) 04 YEREVAN 1651 B) YEREVAN 1705

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SUMMARY:

11. (SBU) The GOAM draft budget for 2006, currently under debate in the National Assembly, envisages significant increases in health and social security expenditures paid for by increased tax revenue and deficit spending. The budget is based on an exchange rate of AMD 420 to the dollar, a dram appreciation of approximately 8 percent from the current rate. The IMF Country Representative describes the 2006 draft budget as consistent with program targets and in line with Armenia's Poverty Reduction Strategy. End Summary.

DRAFT BUDGET: HEALTH AND SOCIAL SECURITY EXPENDITURES UP

12. (SBU) The GOAM recently submitted its draft 2006 budget to the National Assembly. The draft is currently under debate and will likely be approved by the end of November. Under the draft proposal, total expenditures for 2006 will increase by almost 15 percent compared to 2005 (from AMD 394.6 billion to AMD 451.9 billion -- approximately USD 1 billion at the projected exchange rate of AMD 420 to the dollar). The projected total expenditures in the 2006 budget are the largest since Armenian independence, with significant increases in health care and social security spending. Health care expenditures are projected to be AMD 39.1 billion (approximately USD 93 million at the projected exchange rate of AMD 420 to the dollar) an increase of AMD 6.8 billion compared to 2005. Social security spending is projected to reach AMD 55.4 billion (approximately USD 132 million at a rate of AMD 420 to the dollar) up by AMD 8.8 billion from 2005 levels. The proposed 2006 budget also envisages increases in public sector wages and defense spending.

"AMBITIOUS" TAX COLLECTION TARGET

13. (SBU) The 2006 draft budget proposes a significant (15.5 percent) increase in tax revenue. The International Monetary Fund (IMF) Country Representative described this target as "ambitious." According to statistics provided by the IMF, tax revenue collection for the first nine months of 2005 was approximately 18.4 percent higher than for the same period in 2004, but still slightly below the IMF target. The GOAM also plans to increase deficit spending to cover 2006 expenditures. Deficit spending is projected to increase by AMD 17.9 billion, from AMD 52 billion in 2005 to AMD 69.9 billion (approximately USD 166 million at a rate of AMD 420 to the dollar) in 2006. The IMF Country Representative told us the draft 2006 budget was consistent with program targets and in line with Armenia's Poverty Reduction Strategy.

CBA PROJECTS 8 PERCENT DRAM APPRECIATION

14. (SBU) The proposed 2006 budget is based on an exchange rate of 420 AMD to the dollar. This estimate, which was agreed upon by both the Central Bank of Armenia (CBA) and the Ministry of Finance and Economy, indicates that the GOAM expects the dram to appreciate against the dollar by about 8 percent in 2006. The current exchange rate is approximately 450 AMD to the dollar, but it has been fluctuating on a near-daily basis. According to Head of the Financial Monitoring Center and former Advisor to the Chairman of the CBA Nerves Yeristyan, the CBA set the target exchange rate in anticipation of an increase of dollar flows into Armenia due, in part, to a possible Millennium Challenge Corporation grant and a confirmed USD 60 million grant from the Lincy Foundation. Yeristyan said the CBA planned to sterilize a portion of the in-flows, but expected that there will be some appreciation of the dram. According to Yeristyan, the higher priority for the CBA is not to exceed the IMF-sanctioned 3 percent inflation rate. In previous years, the CBA has been accused of manipulating the exchange rate in order to mask greater than anticipated increases in inflation (ref A).

15. (SBU) The estimated appreciation of the dram was greater in last year's 2005 budget than it is in the 2006 budget. The average exchange rate in 2004 was 533, but the rate set in the 2005 budget was 468 (13 percent lower than the 2004 average). This year the margin between the average exchange rate and the rate used for the 2006 budget is 9 percent. The average rate to-date for 2005 is 459 and the 2006 budget target is 420.

COMMENT: ARMENIA ON TRACK WITH POVERTY REDUCTION STRATEGY

16. (SBU) Steady growth (ref B) and increased tax revenue have allowed the GOAM to propose additional health and social security spending for 2006. While there is an on-going need for reform within the tax sector, this draft budget shows that the GOAM is making progress towards improving its economic position and meeting the requirements of its Poverty Reduction Strategy. The projected appreciation of the dram, should it materialize, may pose a threat to Armenian exports. Current growth rates, however, suggest that the impact on exports to date has been limited.

EVANS